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By Ambassador (Ret.) Adam Ereli and Dr. Theodore Karasik

Over the last eight years, considerations of politics and national security have come to play an influential role in the decision-making of Gulf sovereign wealth funds.

In 2015, the Qatar Investment Authority (QIA) — Qatar's sovereign wealth fund (SWF) — declared its intention to invest $35 billion in the United States over the coming five years. In making the announcement, a senior Qatari official noted that the state was taking this step not because of politics, but because it *"made good business sense."*

He was half right. While it was certainly true that the US market offered strong rates of return, it stretched credulity to argue that political considerations did not factor into Qatar's investment decision. For the past decade or so, disagreements between Qatar and the United States over a host of issues, from terror financing to regional power dynamics, had soured the bilateral relationship. Qatar's former ruler, Emir Hamad bin Khalifa al-Thani, had transferred power to his son, Sheikh Tamim bin Hamad al-Thani, a little over a year earlier, and the new emir was keen to turn a page in his nation's relationship with arguably its most important ally. The **opening of a QIA office in New York City** in December of 2014 was accompanied by great fanfare and served to demonstrate Qatar's seriousness of purpose.

Qatar is not alone in using its national wealth to advance national interests. In at least four ways, changing regional power dynamics have injected geopolitics into the strategic decision-making of the Saudi, Emirati and Kuwaiti sovereign funds to an unprecedented degree.

First, regional conflict and political instability: Governing structures and national authorities are under assault as never before. The Arab Spring, the potency of ISIS and other extremist jihadist movements and the attendant conflicts in Syria, Iraq, Yemen, and Libya have upended the region's political order. While always a concern, the issues of regime stability and internal security have taken on new saliency and have compelled rulers to take enhanced measures to protect themselves.

Second, great power rivalry: Since independence, the nations of the Gulf have regarded the United States as their security bulwark. The policies of the Obama administration fundamentally altered this calculus. Rightly or wrongly, regional leaders interpreted the nuclear agreement with Iran, the U.S. drawdown in Iraq, the U.S. handling of Egyptian President Hosni Mubarak's transfer of power and its failure to assert power in the Syrian conflict as evidence of a weakening of America's commitment to the region. Russia's growing military and diplomatic role in regional affairs, combined with persistent and more potent Iranian influence, have transformed the Gulf Cooperation Council (GCC) into a new front in great power competition, which regional leaders must take into account.

Third, a new generation of leadership: Millennials now rule Qatar and Saudi Arabia. The UAE has been governed by an exceptionally forward-looking and interventionist leadership for over 10 years. With this generational change has come a new approach to national power. These leaders are not content to let others fight their battles for them and are resolutely developing indigenous force projection capabilities. They are both adept at and inclined to use all elements of national power — economic, political and military — in an integrated and mutually reinforcing way to protect their interests.

Fourth, the GCC rift and zero-sum thinking: The ongoing dispute between Qatar and the *"quartet"* (Saudi Arabia, UAE, Bahrain, and Egypt) will have a spillover effect on the region's relations with external actors. Hard as it may be for outsiders to fathom, each of the parties to this dispute believes the other presents a credible threat to its national survival. As a result, all are taking steps to protect their sovereignty, and this includes where they invest their national wealth. Moreover, gain for one side is necessarily regarded as a loss for the other, which injects a level of acrimony and intransigence that will persist for a considerable time to come.

IMPACT ON INVESTMENT DECISIONS

Two areas, in particular, are indicative of this accelerating trend in GCC strategic investment: Russia and Islamic Asia. Even if allowances are made for sectoral and geographic diversification, the level of allocations to these markets is out of proportion to their size and viability.

In the case of Russia, the **Gulf states are using their investments as leverage** to advance their respective interests with regard to Iran, Syria, Yemen, and Libya; as a hedge against great power competition in the region; and as a political tool in the context of their intra-GCC rivalries. As the world's largest Muslim nation, **Indonesia, along with Malaysia and Thailand, hold special interest for Saudi Arabia** — which is perennially concerned with asserting its primacy as leader of Sunni Islam — as well as for the UAE, which seeks to make common cause with like-minded leaders sympathetic to its policies of limiting the role of political Islam and countering radical extremism.

In 2011, Russia established the Russian Direct Investment Fund (RDIF), with seed capital of $10 billion. Since then, Gulf sovereign wealth funds have earmarked at least $20 billion for investment in Russia, according to RDIF's CEO Kirill Demetriev. These placements include: a 2015 commitment of $10 billion by Saudi Arabia's Public Investment Fund (PIF) in a partnership with RDIF to invest in Russian infrastructure and agricultural projects; **$5 billion** in 2013 from the Abu Dhabi Investment Fund for infrastructure projects; allocation of **$2 billion** by QIA to a joint investment fund with RDIF; the contribution of $1 billion by the UAE's Mubadala Development Company to a co-investment fund with RDIF; and allocations of $500 million in 2012 and 2015 by the Kuwait Investment Authority (KIA) to an automatic co-investment mechanism with RDIF. In addition to a $2-billion commitment to RDIF, QIA has taken a 9.75 stake in Rosneft valued at $6.83 billion, a **24.9% stake in St. Petersburg's Pulkovo Airport** and a $500-million stake in VTB, a Russian bank currently under international sanctions.

In February 2016, the governments of **Russia, the UAE, and Egypt announced the creation of joint investment fund** to finance large-scale infrastructure projects in Egypt and seeded the fund with $500 million in July of the same year.

As a signal of Indonesia and Malaysia's importance, King Salman of Saudi Arabia included them, along with China and Japan, on his tour of Asia in March of this year. Indonesia's ambassador to the UAE stated in October that his country was aiming to increase the level of **Emirati investment** from its current level of $2 billion to $10 billion. **Qatar has invested $15 billion in Malaysia.** In 2011, Malaysia and Qatar announced a **$2-billion joint investment fund**. Two years later, Qatar began investing $5 billion in the **Pengerang Integrated Petroleum Complex development** in Johor and another $5 billion in Malaysia's tourism, real estate, banking and other sectors.

Qatar and Indonesia created a similar fund in 2008, now worth roughly $1 billion. The Qataris are investors in Indonesia's energy, infrastructure, banking, telecommunications, and mining sectors. Such investments have included $350 million in a **gas power plant in North Sumatra**, as well as an agreement between QIA and PT Saran Multi Infrastructure worth $1 billion.

DOWNSIDE RISK

Money and politics make a combustible mix: If you don't get the formula right, it can blow up in your face. Foreign governments, corporate leaderships and the investment community face serious issues of financial risk and legal liability in the current investment climate. The UAE's experience with 1MDB and IPIC is a case in point. In April, 1MDB agreed to pay IPIC $1.2 billion to settle a complaint that it reneged on the terms of a bailout IPIC provided in 2015. The two companies also agreed to enter into good-faith discussions about other disputed payments, which may total as much as $3.5 billion. Last July, investigators at **U.S. Justice Department** alleged that former officials from both IPIC and 1MDB had benefited from fraudulent financial transactions related to the investment.

Due diligence on SWFs has always posed a challenge. As the Gulf states come into their own as strategic investors on the international scene, the need for greater transparency and accountability becomes more salient. What are the political risk factors? Who are the sovereign and corporate co-investors? What are their track records and governance structures? Who really controls them and what could change? How willing are they to open their books for review and analysis? Will they accept and be bound by internationally recognized dispute resolution mechanisms and authorities?

Such questions are all the more timely, given the scope and complexity of today's deals. Take the **NEOM project** for example. In October, Saudi Arabia's SWF, the Public Investment Fund (PIF), hosted the Future Investment Initiative, at which **Crown Prince Mohamed bin Salman** unveiled his country's plans to build a 10,230-square-mile business and industrial zone that links with Jordan and Egypt and focuses energy and water, biotechnology, food, advanced manufacturing and entertainment industries.

The project will be backed by more than $500 billion from the Saudi government, PIF and local and international investors. RDIF CEO Demetriev immediately pledged ***"several billion dollars"*** to the project. NEOM is ambitious, transformative and potentially lucrative. When considered in the context of multi-party investments, sovereign participation, oversight, regulatory and political constraints and geopolitical tensions, however, NEOM poses a potentially tangled web of risk and possible conflicts of interest.

UNDERSTANDING SWFS

In weighing the viability of such projects, international investors would do well to investigate thoroughly the interconnective tissue between Arab sovereign wealth funds and Middle East states undergoing rapid transformation.

Every sovereign wealth fund is different, requiring each to be understood individually in the context of the particular transaction being entered into. It is critical to conduct proper due diligence and have comprehensive and accurate information about the SWF and how it operates. This information is often not disclosed publicly or, if disclosed, does not tell the whole story, as SWFs are generally highly protective of their confidential information and typically do not reveal information that could cause embarrassment or political problems.

The differences among SWFs can be quite dramatic. For example, there are some very sophisticated and well-established SWFs that generally make investments solely on the merits and have excellent internal analysts and deal-making teams to vet and complete deals. They can make decisions quickly and are not subject to the slow decision-making process that stems from lack of familiarity or experience. This makes them ideal partners for private equity funds, co-investors or debt providers.

Others are newly formed and relatively unsophisticated and therefore rely primarily on third parties to analyze and bring them investments. In some cases, governments or ruling families may exert undue influence on the decision-making process, leading to expensive purchases of “trophy” assets and other questionable economic decisions. SWFs can also be excessively bureaucratic, leading to delays and unpredictable decision-making, in which no one accepts responsibility for a decision and everyone plays the blame game. Therefore, depending on the circumstances, a particular SWF’s commitment to a transaction may be of greater or less probative value in accessing the merits of the deal.

Some SWFs have been formed with potentially conflicting incentives, not only to make profitable investments but also to further political and social objectives. Others can be used for political purposes even though that is not their mandate. This can cause a fundamental divergence between the interests of the SWF and the other purely economic investors. This analysis becomes more complicated because the investment of a local or regional SWF in project finance in some contexts can constitute a stamp of approval and protection against governmental risks.

For example, if the investment is in an infrastructure project that relies on governmental cooperation and support, the commitment by local SWFs may provide insurance against unfriendly government actions. However, this alignment of interests is far from perfect and not automatic in all cases. Even if the SWF is a principal investor, if the local government needs money, it may decide to impose taxes or other impositions on the project. This could be because different factions within the government have competing priorities or the government could earn more from the increased tax revenues/assessments than the SWF would make from its investment.

There is also the risk of bribery or corruption. SWFs are improving internal controls, but several recent events have shown that the protections in place have not always been adequate. An SWF investment may create the perception of legitimacy, while the real reasons for the investment may be hidden and much more nefarious. In addition to the 1MDB and IPIC scenarios, the poor investments by the Libyan Investment Authority (LIA) during the financial crisis are cases in point. A third party would be wise to study this aspect carefully as there are the possibilities of economic loss, legal liability and the loss of reputation.

With good reason, SWFs are generally viewed as stable long-term investors with deep pockets. However, this depends on history, geography, and other factors. Politics can change very quickly in countries that rely primarily on mineral resources for their wealth and do not have long histories of stable governance. In the Middle East, this is true more now than ever, with myriad potential threats amid the current upheaval. A new regime often has little use for the projects sponsored by the prior government, and the consequences on third-party investors can be devastating.

The policy and financial communities would benefit greatly from enhanced research and analysis by academia and think tanks of the issue relating to the geopolitics of SWF investments. There already exists a nascent community of observers in this field, but current trends make clear that a deeper understanding of SWF activity and its implications for a wide variety of stakeholders is needed.

RISK MITIGATION STRATEGIES

Bearing in mind that sovereign investment decision-making is increasingly influenced by considerations of national security and recognizing that each SWF and each transaction is unique, what can actions can concerned parties (e.g., debt or equity investors, SWF counterparties or service/technology providers) take to mitigate risk?

First, local political due diligence: A sophisticated knowledge of the political risks at the local level needs
to be factored into any business decision. This should include an understanding of geospatial conditions such as family ties, social status and previous and existing business relationships. The geopolitics of sovereign investing also requires scrutiny. Arab states are using their SWFs as political tools, often in tandem with Russia's efforts at regional power projection. What are the respective political and economic interests of the SWFs or other national institutions involved in a project, and what potential conflicts do these relationships entail if circumstances change?

Second, global political due diligence: Any investor would do well to understand the position of and consult with the U.S. and European governmental entities before the commitment of resources in a deal involving an SWF. In most scenarios involving significant levels of investment, the U.S. government will have an interest and could present obstacles. Ventures with connections, however tangential, to Russia, Iran or entities related to those countries will come under increasing scrutiny. The ever-expanding reach of U.S. sanctions policies, which include not only named entities but any outside entity doing business with them, can ensnare even the most well-intentioned investor. For these reasons, it is advisable to seek the view of concerned agencies (State Department, Treasury, Congress) on transactions in potentially sensitive countries and/or sectors. Officials in Brussels need to be also contacted to guarantee a safe and secure way forward in the transaction, especially if EU and U.S. policy are not in sync on sanctions.

Third, economic forensics: For those who analyze the financial aspects of the sovereign activity, capturing the relevant data requires the peeling away of many layers of opaqueness. Given that each SWF is structured differently, there is a strong requirement to focus on their individual operations and especially joint ventures. Who are the beneficial owners? What is the amount of commitment and who are the owners of the fund? What are the sources of their assets, and are you confident in your compliance with know your customer requirements? The issue here is that if there are funds involved that are directly or indirectly derived from illegal activities, it can have a devastating impact on the investment and result in the seizure of assets.

Fourth, comparative advantage: Investors considering joint ventures or other forms of partnerships that involve the building or establishment of local facilities (infrastructure, manufacturing, research and development, re-export, etc.) should comparison shop among the various jurisdictions seeking foreign investment and technology. What are the comparative advantages/disadvantages of respective countries and regulatory regimes for the outside investor, even if the deal is being done in conjunction with a sovereign partner? Beyond apparent factors such as tax incentives, availability of skilled labor, energy costs, repatriation of profits, dispute resolution mechanisms, labor markets, legal and intellectual property rights protections, etc., what are the "unknowns," and how does all of this compare with regional competitors? A thorough study of these and related issues is one of the best ways to avoid buyer's remorse.

Fifth, legal safeguards: The transaction should be structured in such a way as to provide the maximum legal and economic safeguards possible. Among other requirements, an investor is wise to attempt to negotiate tight and comprehensive contracts, effective dispute resolution mechanisms and access to substantial assets in the event of a default. Treaty protections and the support of the home government of the investor can also be quite helpful.

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